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SUBJECT: EAST JAVA: WAITING FOR THE OTHER SHOE, ISOLATION IS NO  
INSULATION FROM GLOBAL FINANCIAL CRISIS

REF: JAKARTA 1940

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11. (SBU) Summary: Uncertainty about the full extent of the global financial crisis continues to cause a lack of liquidity in all sectors of East Java's economy and the Indonesian economy more broadly. This was the theme of a roundtable discussion with visiting EAP/MTS Director Kamala Lakhdir, which included a Bank Indonesia official and leading East Java business people. Participants agreed that uncertainty in short-term market prices for finished goods and inputs and especially tight credit have already had a serious impact on the health of East Java's overall economy. Businesses are unable to take advantage of dropping prices for inputs driven by low expectations for growth due to tightening credit. Business people asked what the United States might do to restore confidence and reverse this trend. End Summary

12. (SBU) Congen Surabaya Principal Officer, Pol/Econ Officer and visiting EAP/MTS Director Kamala Lakhdir met with five local economic observers on October 27. Each shared local views on the current financial crisis, they were: Mr. Indra Fauzi of Regional Economic Development Institute (REDI); Mr. Wibisono, Deputy Director of the Bank of Indonesia (Surabaya); Mr. Frank Pandji, Director of PT Mepoly Plastics; Ms. Erawati, Executive Secretary of the Indonesian Textile Association; and Mr. Novi Saputra, Marketing Director of PT. Kelola Mina Laut, a seafood processing company.

13. (SBU) Indonesian Finance Minister Sri Mulyani has recently both reassured and warned Indonesians that while Indonesia has diversified its exports in the decade following the Asian Financial crisis, it is still exposed to a downturn in the U.S. market. Indonesia's vulnerability is the nation's strong links to Southeast Asian markets more reliant on US consumers. Participants touched on key indicators in each of their industries that indicate trouble on the horizon -- in particular, concern for the future has slowed the circulation of cash. Shifts in commodity prices, tightening credit and a creeping uncertainty have spawned some confusing trends.

14. (SBU) The East Java textile industry runs on polyester staple fiber and its price is directly tied to the price of oil.

According to Ms. Erawati, recent plunging oil prices have caused a drop in the price of polyester fiber but this hasn't taken pressure off the industry. Paradoxically, the causes of the fiber's price drop -- low oil prices -- are in part driven by expectations of reduced consumption in the U.S. This same expectation drives a lack of confidence in export industries by Indonesian banks. Such is the uncertainty that local banks are delaying payment of letters of credit until full terms are met, apparently concerned that foreign customers and their financial institutions could fail in the near term. The lack of trust between banks and a wait-and-see attitude towards U.S. consumer demand continues to tighten textile companies' access to credit in what might otherwise be a profitable period.

15. (SBU) The seafood processing company, Kelola Mina Laut, has customers on nearly every continent and has thus distributed its risk geographically. While demand for seafood has not softened, it has moved down the food chain towards less expensive seafood products. Mr. Saputra sees this instability as an opportunity for market leaders in a given sector. Companies recognized as the most stable can now gain market share as banks and customers put pressure on smaller competitors by choosing large, reliable suppliers over suppliers who might go belly up.

16. (SBU) Frank Pandji's plastic hose and coupling manufacturer could be a poster child for the sort of "unlinked" Indonesian business presumably unharmed by the foreign market fluctuations described by Finance Minister Sri Mulyani. However, Frank Pandji told us that while his products target the Indonesian

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market almost exclusively, he expects a delayed impact on demand as exporters using his products see a drop in overseas demand. Reflecting hard-won experience during the Asian financial crisis, Mr. Pandji said he has amassed cash reserves roughly three times his total outstanding credit in anticipation of tightening credit.

17. (SBU) The Deputy Director of Bank Indonesia expressed concern that rumors are driving a lot of economic behavior and uncertainty is eroding otherwise sound banking practices. East Java's annual inflation rate is running at 11.39%, compared to 12.58% nationally, reflecting different economic climates. Overseas workers have a significant role in East Java's economy.

An estimated 140 million USD will come back to East Java from overseas workers in 2008. Roughly 50% of remittances from overseas workers are sent electronically, the rest is carried home in cash. However, precise statistics are unavailable because wire transfer companies are not required to report amounts transferred, according to Wibisono. A softening labor market at home and abroad could lead to increasing pressures on East Java's economy. The most vulnerable among an estimated 70,000 of East Java's overseas workers could be forced out of work abroad, and prospective overseas job seekers might be forced to rely solely on the East Java job market. East Java's official unemployment rate is currently 10%. However, since an individual working only one day in the two week period preceding the survey is counted as employed, unemployment figures calculated on a US model would push the number to several times its official level. Mr. Wibisono echoed the assumption of all at the discussion that while East Java is generally insulated from the direct impacts of sharp market fluctuations and uncertainty, it is only a matter of time before serious instability overseas will make itself felt in East Java.

MCCLELLAND